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Industrial strategy

Europe to control foreign subsidies threatening the internal market

by **Alec Burnside** and **Marjolein De Backer**

On 5 May the European Commission issued its proposal to create wide-ranging powers to tackle foreign subsidies which may distort competition in the European Union (EU). The proposal follows the White Paper issued in June last year and maintains the three-fold controls it foresaw:

- A mandatory notification regime for mergers and acquisitions (M&A) if one of the parties is established in the EU;
- A mandatory notification for companies bidding in certain public procurement procedures; and
- A catch-all ex officio power to commence an investigation up to 10 years after a subsidy was received.

If adopted, the regulation would be a significant addition to the Commission's armoury, with multiple ramifications for foreign businesses active in the EU. And conversely, the regulation may provoke backlash elsewhere, with implications for EU firms doing business in foreign markets.

This article summarises the key aspects of the proposal and puts it into the broader context of Europe's newly protectionist industrial strategy.

Europe's industrial strategy

On 5 May the Commission issued an update of the EU's industrial strategy to ensure that it takes full account of the new circumstances following Covid-19, so as to strengthen the resilience of the internal market. The Commission considers the foreign subsidies proposal to be a key element in delivering the industrial strategy, by ensuring a level playing field and by promoting a fair and competitive single market. Since 2019, concerns have grown that the openness of the internal market has left European businesses vulnerable to takeover by companies benefiting from foreign government support, and more generally to competition from such companies. Although the proposed regulatory framework will capture foreign subsidies from all third countries, so including for example the US and Russia (and indeed the UK), the EU's concerns seem largely centred on China. These concerns pre-date Ursula von der Leyen's presidency and are reflected in the Commission's 2019 paper on the EU-China strategic outlook, which specifically called out the inadequacy of EU laws to tackle all potentially distortive effects of unfair subsidies or support by third countries. The economic uncertainties brought on by the Covid-19 pandemic have undoubtedly exacerbated fears that EU businesses may be exposed to unfair competition. There are international instruments, such as the World Trade Organization Agreement on Subsidies and Countervailing Measures, which address this to a certain extent, but these are seen as insufficient. The same is true of existing EU regulations or national laws on merger control, foreign direct investment (FDI) screening, state aid and public procurement.

In June 2020 the Commission issued a White Paper with an analysis of the situation and proposed avenues for action, inviting public comment. This consultation exercise did not, however, lead to any fundamental change in approach. Vice President Vestager stressed during her press conference announcing the foreign subsidies proposal that EU member states grant many subsidies to their national companies; but these are *controlled*, Vestager said, unlike foreign subsidies. It is this gap that the proposal addresses, borrowing disciplines from EU state aid practice and applying them to foreign subsidies.

It remains to be seen whether there will be political support for the proposal, given the potential for controversy around raising barriers to inbound investment into the EU, and the risk of retaliatory measures in foreign markets. The regulation sets higher thresholds than those proposed in the White Paper, no doubt seeking to strike the right balance between fair competition versus the openness of the internal market to foreign players; but views will differ whether that balance has been appropriately set. The China Chamber of Commerce to the EU has expressed general concerns. It was joined in this by the American Chamber of Commerce to the EU, which called for a focus on "the distortive effect of subsidies

available in non-market economies with well-funded state-owned enterprises". The explanatory memorandum to the proposal and the presentation by Vice President Vestager at the press conference indicate that the proposal has broad support from the member states, the Council of Ministers and members of the European Parliament, as well as businesses contributing to the consultation.

It is true that member states have sometimes aired concerns about the anti-competitive effects of foreign subsidies. The German Federal Cartel Office (FCO), for example, examined such concerns in a 2019 merger control decision (*CRRC/Vossloh*, Case B4-115/19). While the transaction was ultimately cleared, the FCO closely examined the particularities associated with the acquisition of a European company by a Chinese state-owned enterprise (SOE). In the FCO's press release, Andreas Mundt, the president of the FCO, explained that: "Possible state subsidies, the availability of technical and financial means and strategic advantages from other shareholdings were considered in the competitive assessment of the merger. We also looked into the threat of low-price and dumping strategies and the cost advantages resulting from CRRC's state-subsidised activities in many other markets. CRRC plays an important role in China's industry strategies."

Nevertheless, it would not be the first time that a Commission initiative in relation to foreign subsidies fails to proceed due to opposition from member states. The Commission's proposed International Procurement Instrument,[1] for example, suggested that Europe may block non-European companies from participating in European tenders if their home country is a state which applies discriminatory rules to foreign companies in its procurement procedures. This proposal has not advanced, apparently in the face of member state opposition said to reflect industry concerns at likely repercussions for them in foreign markets. While Vice President Vestager said she hopes the proposal will be adopted as soon as possible, it may take until the end of 2022 before a compromise is reached between the Commission, the Parliament and the Council. The Commission is then also likely to issue an Implementing Regulation and possibly guidelines to address procedural and practical aspects of the proposal.

Key aspects of the proposal

What is a foreign subsidy?

The definition of a "foreign subsidy" incorporates many elements of EU state aid law. In particular, a foreign subsidy is one satisfying these tests:

- Any financial contribution – capital injections, loans, preferential tax treatment, or the provision of goods or services, or the purchase of goods or services, on preferential terms;
- Granted by a government, governmental authorities at any level, or public or private entities whose actions can be attributed to the non-EU country;
- Which confers a benefit on the recipient – this is determined on the basis of the usual practice of private investors in similar circumstances; and
- One limited (in law or in fact) to an individual company or industry or to a group of companies or industries (ie selectivity).

If the subsidies did not exceed €5 million over three consecutive years, they are deemed to be unproblematic. This is a notably higher threshold than the de minimis test applicable to European state aid (€200,000) which was imported in last year's White Paper.

A question which will inevitably arise is whether SOEs will necessarily be considered as receiving "foreign subsidies". There is nothing in the explanatory memorandum that addresses this question as a matter of principle, but such companies will certainly be in focus as possible beneficiaries of *direct* and *indirect* government subsidies, as noted in the Commission's Impact Assessment. State aid precedent in EU practice easily reaches indirect subsidies, for example, banking loans on preferential terms in some way reflecting the state ownership. Acquisitions by SOEs are therefore likely candidates for the Commission's use of the power described below, to call in transactions even if the threshold of direct subsidies is not met. The same applies to public procurement procedures. And further, such companies may be a target of a Commission sector inquiry.

The EU treaty lays down the important principle of non-discrimination between state-owned and private sector businesses (Article 345 TFEU), but this does not shield EU SOEs from state aid controls: a member state has to act like a private market economy operator as regards the management of an SOE, otherwise the state aid rules apply. The Commission's Guidance Paper on state aid-compliant financing, restructuring, and privatisation of SOEs from 2012 sought to raise awareness among member states that state aid rules must also be complied with in that context.[2] So extending the non-discrimination principle to foreign SOEs would not shield them from the proposed Regulation. Indeed that principle has been applied to foreign SOEs in the merger control context: see, for example, the 2016 *Hinkley Point* case (M.7850 *EDF/CGN*) examining the extent to which one Chinese SOE should be considered part of a wider SOE grouping, a question which turns on the autonomy of management. That practice may well have relevant application in relation to the proposed Regulation, to determine whether the SOE or its larger grouping received governmental support in the last three years which extended beyond what could be expected from a private investor.

Which foreign subsidies are considered harmful?

A foreign subsidy is deemed to distort the internal market if it is liable to improve the competitive position of the beneficiary in the internal market and this has actual or potential effects on competition in the internal market.

Some types of foreign subsidies are, according to the proposal, likely to distort the internal market: foreign subsidies granted to ailing undertakings; unlimited guarantees for debts or liabilities; a foreign subsidy directly facilitating a concentration; or a foreign subsidy enabling a company to submit an unduly advantageous tender. All other types of subsidies will be assessed on a case-by-case basis taking into account, inter alia, the following criteria: amount of the subsidy; nature of the subsidy; situation of the company (SME or large multinational) and the markets concerned (based on the White Paper, for example, level of excess capacity, level of concentration, level of maturity); level of activity of the beneficiary in Europe; and the purpose and conditions attached to the foreign subsidy as well as its use in the internal market.

The actual or potential distortion caused by the foreign subsidies will, where necessary, be balanced against positive effects on the relevant economic activity, a concept familiar from trade law. This is narrower than the "European interest" test originally proposed in the White Paper which allowed broader European interests to counterbalance the distortions, ie, the positive impact within the EU or on a public policy interest recognised by the EU such as employment, environmental protection, digital transformation, security or public order.

Three forms of control

The proposal creates three different disciplines to address the distortions caused by foreign subsidies. A given subsidy may come to be assessed more than once, for example, if first notified as part of a concentration or procurement exercise, and then later relevant again in other circumstances.

1. **Ex officio review of foreign subsidies** – a general power to address (ex post) foreign subsidies that cause distortions in the internal market. The Commission will have 10 years to intervene from the grant of the subsidy. The limitation period will be interrupted and restarted by any action taken by the Commission in relation to the foreign subsidy.

   The Commission expects to review 30 to 45 cases a year on this basis, including cases which do not fall within the thresholds for the concentrations and public procurement regimes. It is within the Commission's discretion to decide whether to use the ex officio tool, and this will significantly depend on the resources available, a Commission official said at a recent event. One target could be subsidised pricing, he added, and whereas the Commission would have the power to investigate completed M&A transactions with the ex officio tool, the Commission expects to do so only in highly exceptional circumstances.
2. **Concentrations** – an ex ante regime introducing a mandatory advance notification for acquirers who benefited from financial contributions from non-EU countries in the three calendar years prior to a transaction. The regime will apply to acquisitions of control in the sense of the EU Merger Regulation when: (1) the target, the joint venture, or at least one of the acquiring undertakings is established in the EU and one of them generates an aggregate EU turnover of at least €500 million; and (2) the parties to the transaction received from non-European countries an aggregate financial contribution in the three calendar years prior to the notification of more than €50 million. The proposal also includes a catch-all provision which allows the Commission to request a notification of transactions not meeting these thresholds but where the Commission suspects that the parties benefited from foreign subsidies in the three years prior to the concentration. The Commission must do so prior to the completion of the transaction.

   If companies fail to notify, the Commission will be able to call in the transaction and will not be bound by the procedural timelines. It may impose fines on the parties of up to 10 per cent of their aggregate turnover in the preceding business year, where they failed to notify.

   The Commission estimates that around 30 companies per year will be affected by the regime covering concentrations.
3. **Public procurement procedures** – an ex ante regime introducing a mandatory notification for firms participating in a public tender with a value of €250 million or more, and where the bidder (or an important sub-contractor or supplier of the bidder) benefited from foreign subsidies during the three years prior to the notification. If no such subsidies were received, the bidder must submit a declaration to that effect. Failure to submit a notification or declaration will lead to exclusion from the bidding process. In the same way as for concentrations, the Commission has the possibility to request a notification in all cases where it suspects that a company has benefited from foreign subsidies in the three years prior to the submission of the tender or the request to participate in the public procurement procedure.

   Notifications of foreign subsidies will not suspend the public procurement procedures; but the contracting authority will not be allowed to award the contract to a company under investigation.

   If companies fail to notify, the Commission may impose fines of up to 10 per cent of their aggregate turnover in the preceding business year.

The proposal also allows the Commission to conduct market investigations into certain sectors, economic activities or subsidy instruments if there is a particular concern with any of these. But the regulation will apply to companies in all sectors and subsidies received from any non-European country.

Procedure

In all three branches of the regulation the investigation will start with a first phase preliminary review to examine whether there is a foreign subsidy that may distort the internal market. If there is no concern at the end of the preliminary review, the Commission will close its investigation with no intervention, and acquisitions or public tenders can then proceed. The Regulation does not foresee any publication about the preliminary investigation to invite third parties to comment; nor will the Commission publish decisions to close a case at the preliminary review stage. It will only inform the companies concerned.

If, however, there is evidence that the foreign subsidy may distort the functioning of the internal market, the Commission will open an in-depth investigation. At that time the Commission will publish a notice in the Official Journal of the European Union inviting comments from third parties. It will also summarise its findings in a decision to the parties involved. The second phase investigation will be closed by adopting corrective measures or commitments, or a no-objections decision. Parties will have been given the opportunity to comment on the Commission's concerns before a decision is taken and the Commission will be advised by a Committee composed of representatives of member states.

As regards concentrations, the Phase 1 and Phase 2 timetable is similar to that of EU merger investigations (25 working days and 90 working days, respectively, which can be extended and suspended). For public procurement cases, the Commission has 60 days for the Phase 1 review which extends to 200 days if a Phase 2 investigation is opened. The Commission will publish a non-confidential version of its Phase 2 decisions.

In all cases the Commission will be able to compel companies to provide information requested from them, and will also be empowered to request information from other market participants as well as the non-EU government in question. It will also be able to carry out inspections at EU locations – as well as in non-European countries, although subject to approval from the relevant government. If companies do not provide information in a timely way, or provide incomplete, incorrect or misleading information, or do not cooperate, the Commission will be able to impose fines and periodic penalties. Despite these powers, the Commission recognises that it may be challenging to gather the necessary information and it is therefore empowered, in the absence of cooperation, to take a decision on the basis of the available facts, an approach familiar from dumping investigations.

Measures to redress or prevent the distortions caused by foreign subsidies

If the in-depth investigation confirms the Commission's concerns, it will be able to impose measures to redress or prevent the distortions in the EU market ("redressive measures"), or to accept commitments from the companies involved. The proposal provides the following examples: offering fair and non-discriminatory access to an infrastructure acquired or supported by the foreign subsidies; reducing capacity or market presence; refraining from certain investments; licensing on fair, reasonable and non-discriminatory terms of assets acquired or developed with the help of foreign subsidies; publication of results of R&D; divestment of certain assets; dissolving the concentration; and repaying the foreign subsidy (plus interest). The Commission will take into account any positive effects of the foreign subsidies on the relevant economic activity when assessing the effectiveness of redressive measures or commitments.

Interim measures may be adopted during the procedure, where there are indications that a foreign subsidy distorts the internal market and not intervening would create a serious risk of substantial and irreparable damage to competition in the internal market. These conditions are similar to those for interim measures powers under EU competition law – which have rarely been applied due to the high thresholds set in decisional practice and court judgments, although the Commission imposed interim measures on Broadcom in 2019 during an abuse of dominance investigation.

What's next?

The proposal will now be reviewed by the European Parliament and the Council of Ministers, which will each issue an amended text and then seek to find a compromise together with the Commission. The proposal will no doubt spur significant debate: while it reflects a growing protectionist sentiment in the EU, it may be seen as a threat to incoming foreign investment, with the risk also of backlash in foreign markets. The proposal may well undergo further changes in the legislative process ahead and is unlikely to be adopted before the end of 2022.

The current proposal foresees that, once adopted, the regulation will enter into force 20 days after its publication in the Official Journal and will apply in full six months later. The regulation's ex officio regime would apply retroactively to foreign subsidies granted in the 10 years prior to that date, while the public procurement regime would apply to subsidies granted in the three years prior to the date of application but not to public procurement procedures initiated before that date. The regulation will not affect concentrations implemented before the date of application.

The three proposed instruments will increase the administrative burden for companies doing business in the EU. They complement the existing EU legislative framework and do not replace any existing instruments. Foreign – and European – companies benefiting from foreign subsidies may, in particular in the case of acquisitions, need to file entirely separate notifications under the EU Merger Regulation, national FDI laws, and the newly proposed foreign subsidies instrument.

It will no doubt be relevant *where* in the Commission the powers reside: while the proposal is silent on that matter, every indication is that this would become a responsibility of DG Competition, given the similarity in procedures and

the borrowing of so many notions from EU state aid law. It is also pertinent that it is Vice President Vestager who has taken the lead on the proposal. Perhaps though there would be particular liaison with DG Trade, where the Commission's FDI powers are housed, and DG Grow, which is responsible for procurement laws. In principle there will be distinct procedures under the different instruments, each addressing different aspects of a given acquisition, and entailing different commitments or remedies. But all decisions are ultimately taken by (or in the name of) the College of Commissioners. Achieving coherence, de facto or in a more formal way, will become a live issue, as yet unaddressed. Certainly, it would stretch credulity to imagine that there would be any kind of hermetic separation between multiple procedures all running in different parts of the Commission in relation to the same set of facts.

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Endnotes

1. Available at: https://ec.europa.eu/growth/single-market/public-procurement/international_en#:~:text=International%20Procurement%20Instrument&text=At%20the%20same%20time%2C%20it,participating%20in%20the%20EU%20market.
2. Available at: https://ec.europa.eu/competition/state_aid/studies_reports/swd_guidance_paper_en.pdf.

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